LIBRARY
SUPREME COURT, U. S.

Supreme Court, U. S.
FILED
JUN 23 1975
MICHAEL RODAK, JR., CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1974

No. 74-1627

ARTHUR W. BROWN, Receiver - - Petitioner

versus

COMMONWEALTH OF KENTUCKY
E. G. ADAMS
ROBERT L. MUSSELMAN and
THOMAS G. FLORENCE - - - Respondents

PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

ARTHUR W. GRAFTON
STUART E. LAMPE
JAMES N. WILLIAMS, JR.,
WYATT, GRAFTON & SLOSS
28th Floor—Citizens Plaza
Louisville, Kentucky 40202
Counsel for Petitioner

WESTERFIELD-BONTE CO., 619 W. KENTUCKY—P.O. BOX 3251, LOUISVILLE, KY.

INDEX

PAGE

Table of Authorities ..... ii–iii

Opinions Below 1– 2

Jurisdiction 2

Question Presented 2

Constitutional and Statutory Provisions Involved 2– 3

Statement of the Case 3– 7

Reasons Why This Petition Should Be Granted 7–14

I.. Congress Has Expressed Its Intent That States Be Subject to the Fraud Provisions of the Federal Securities Acts—There is Liability Even Under *Employees* and *Edelman* 8–11

II. This Court Should Reassess Its Treatment of the Eleventh Amendment Under *Employees* and *Edelman* 12–14

Conclusion 14–15

Appendix A—Relevant Constitutional and Statutory Provisions 1a– 7a

Appendix B—Opinion of Sixth Circuit Court of Appeals 8a–13a

Appendix C—Complaint 14a–20a

Appendix D—Opinion of District Court in Companion—Class Action, *Barr* v. *Commonwealth* 21a–29a

Appendix E—Opinion 30a–52a

Order 30a–32a

Affidavit in Support of Motion to Reconsider 33a–49a

Order Overruling Motion to Reconsider 50a–52a

Order Making Judgment Final 52a

TABLE OF AUTHORITIES

Cases:

PAGE

Baron v. *Shields*, 131 F. Supp. 370 (S.D.N.Y. 1954). 10

Blakely v. *Lisac*, 357 F. Supp. 255 (D.C. Ore. 1972). 11

Competitive Associates, Inc. v. *Laventhal, Krekstein Horwath & Horwath*, ___ F. 2d ___, 1975 CCH Sec. L. Rep. ¶95,090 (2nd Cir. 1975) 11

Duhne v. *New Jersey*, 251 U. S. 311 (1920) 3

Edelman v. *Jordan*, 415 U. S. 651 (1974) ... 3, 9, 12–13, 14

Employees v. *Dept. of Public Health and Welfare*, 411 U. S. 279 (1973) 3, 5, 9, 12–13, 14

Great Northern Life Insurance Co. v. *Read*, 322 U. S. 47 (1944) 3

Hans v. *Louisiana*, 134 U. S. 1 (1890) 3

Herzfeld v. *Laventhal, Krekstein, Horwath & Horwath*, 73-74 CCH Sec. L. Rep. ¶94,574 11

Int. Ladies Garment Workers Union v. *Shields & Co.*, 209 F. Supp. 145 (S.D.N.Y. 1962) 10

MacKethan v. *Commonwealth of Virginia*, 370 F. Supp. 1 (E.D. Va. 1974) 7– 8

Murray v. *Wilson Distilling Co.*, 213 U. S. 151 (1909) 9

Parden v. *Terminal R. Co.*, 377 U. S. 184 (1964) .. 3, 4, 5, 9

SEC v. *Charles A. Morris & Associates, Inc.*, 1972-73 CCH Sec. L. Rep. ¶93,756 (W.D. Tenn. 1973) ... 10

Tcherepnin v. *Knight*, 389 U. S. 332 (1967) 4– 5

Texas Continental Life Ins. Co. v. *Dunne*, 307 F. 2d 242 (6th Cir. 1962) 10

Constitutional Provisions:

Supremacy Clause, Article VI, Clause 2, United States Constitution 2

Eleventh Amendment to United States Constitution 2, 3

BLEED THR

Statutory Provisions:

	PAGE
Securities Act of 1933, 15 U.S.C. §77b, *et seq.*	2, 7, 8, 10, 11, 14
Securites Exchange Act of 1934, 15 U.S.C. § 78a, *et seq.*	2, 14
28 U.S.C. §1254(1)	2
KRS 44.070	12
KRS 289.024	13
KRS 289.451	13
KRS 289.461	13
KRS 289.710	6
KRS 289.730	6

Regulatory Provisions:

Rule 10(b)-5, Securities and Exchange Commission. 3, 10

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1974

No. _____

ARTHUR W. BROWN, Receiver - - *Petitioner*

v.

COMMONWEALTH OF KENTUCKY
E. G. ADAMS
ROBERT L. MUSSELMAN and
THOMAS G. FLORENCE - - - *Respondents*

PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Petitioner, Arthur W. Brown, as Receiver of Prudential Building and Loan Association, respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered on April 2, 1975.

OPINIONS BELOW

The opinion of the Court of Appeals for the Sixth Circuit, dated April 2, 1975, which is reported at 513 F. 2d 333, appears in Appendix B hereto. The opinions

OUGH

of the District Court for the Western District of Kentucky, which are not reported, appear in Appendix E hereto.[1]

JURISDICTION

The judgment of the Court of Appeals was entered on April 2, 1975, and this petition for certiorari was filed within ninety (90) days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTION PRESENTED

Whether jurisdiction lies in the Federal Courts over a suit for monetary relief against the Commonwealth of Kentucky for gross and willful violations by it of the Federal Securities Acts?

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional provisions involved in this Petition are the Supremacy Clause of, and the Eleventh Amendment to, the Constitution of the United States [App. A, p. 1a].

The statutory provisions involved in this Petition are the fraud sections of the Federal Securities Acts, specifically Section 17(a) of the Securities Act of 1933 (15 U.S.C. §77b) [App. A, p. 1a], Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j[b])

[1]The opinion of the District Court refers to an opinion in a companion class action case, alleging the same cause of action, styled *Leslie J. Barr* v. *Commonwealth of Kentucky*. The opinion in the *Barr* case appears in Appendix D.

[App. A, p. 3a] and Rule 10b-5 [App. A, p. 3a], promulgated by the Securities and Exchange Commission under Section 10(b) (herein referred to collectively as the "Federal Securities Acts").

STATEMENT OF THE CASE

This case raises a very serious question of conflict between the Eleventh Amendment and the Federal Securities Acts. The Eleventh Amendment[2] deprives the Federal Courts of jurisdiction to hear cases brought for monetary relief by a private citizen against a state. The Eleventh Amendment, therefore, is a very important obstacle to application of the Federal Securities Acts to the activities of the various states in the securities market. This Court has never ruled on this conflict; in view of the enormous and ever-growing amount of state activity in these markets, this Court should pass on the scope of federal regulation of such state activities. In two very recent decisions, *Employees* v. *Dept. of Public Health and Welfare,* 411 U. S. 279 (1973), and *Edelman* v. *Jordan,* 415 U. S. 651 (1974), this Court, in effect, overruled a prior decision,

---

[2]The Eleventh Amendment provides:

> The judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.

The language of the Amendment has consistently been construed to bar suits by the state's own citizens as well as citizens of other states. *Hans* v. *Louisiana,* 134 U. S. 1 (1890); *Duhne* v. *New Jersey,* 251 U. S. 311 (1920); *Great Northern Life Insurance Co.* v. *Read,* 322 U. S. 47 (1944); *Parden* v. *Terminal R. Co.,* 377 U. S. 184 (1964); *Employees* v. *Department of Public Health and Welfare,* 411 U. S. 279 (1973); *Edelman* v. *Jordan,* 415 U. S. 651 (1974).

Parden v. *Terminal R. Co.*, 377 U. S. 151 (1964), and has made its position clear that this jurisdictional limitation will be strictly applied and suits will be entertained only in the most extraordinary circumstances. We believe those extraordinary circumstances exist in this case. Moreover, even if this case does not fall within this Court's test under the Eleventh Amendment, we believe the Court should reassess that test. If the Court allows the judgment to stand, then it will have created the very antithesis of Anglo-American jurisprudence—a right without a remedy.[3]

Petitioner, as Receiver of Prudential Building and Loan Association (hereinafter "Prudential"), brought this action against the Commonwealth of Kentucky, its former Banking Commissioner and the two state examiners who audited Prudential's books, asserting federal jurisdiction under the Federal Securities Acts. The acts complained of are fraud in connection with the Commonwealth's audit of Prudential, and the withholding of information from the investing public. In *Tcherepnin* v. *Knight*, 389 U. S. 332 (1967), this Court held that deposits (or "shares") in a state-

[3]As this Court stated in *Parden:*

> It would surprise our citizens, we think, to learn that petitioners, who in terms of the language and purposes of the FELA are on precisely the same footing as other railroad workers, must be denied the benefit of the Act simply because the railroad for which they work happens to be owned and operated by a State rather than a private corporation. It would be even more surprising to learn that the FELA does make the Terminal Railway "liable" to petitioners, but, unfortunately, provides no means by which that liability may be enforced. Moreover, such a result would bear the seeds of a substantial impediment to the efficient working of our federalism. 377 U. S., at 197.

BLEED TH

chartered savings and loan association constitute "securities," and there has been no dispute in this action that the depositors of Prudential did in fact purchase "securities."

The Commonwealth moved to dismiss for lack of jurisdiction, citing *Employees*. Petitioner contended that the Commonwealth had waived its jurisdictional immunity under the law as enunciated in *Parden*. The District Court dismissed as to the Commonwealth and the Sixth Circuit affirmed. The District Court overruled a motion to dismiss the individual defendants and they did not participate in the appeal in the Sixth Circuit. We believe a review of this case will demonstate that dismissal of the Commonwealth was in error, and that this Petition should be granted.

In 1953 the Commonwealth of Kentucky issued a savings and loan association charter to H. M. Dunn, Sr. and H. M. Dunn, Jr. The Dunns commenced business as "Prudential Building and Loan Association." Almost from its inception, Prudential was grossly and fraudulently mismanaged. It became so bad that in 1958, when Prudential applied for approval to make federally insured and guaranteed mortgage loans, the Commonwealth's Commissioner of Banking, Earl B. Combs, wrote to the Federal National Mortgage Administration and stated that Prudential's application should be rejected because its "methods of operation are not entirely in accord with what we consider a bona fide savings and loan association" [App. E, p. 34a].

OUGH

In 1961, the Commonwealth actually seized Prudential. Instead of closing Prudential, however, the Commonwealth operated Prudential. Within four (4) months, Prudential was turned back to the Dunns, who thereafter solicited and received millions of dollars of new deposits [App. E, p. 35a]. Almost as swiftly as the money was bilked from the public, it was siphoned into the Dunns' personal real estate projects.

Finally, in 1972, the Commonwealth closed Prudential. By that time the Dunns had loaned themselves over $20,000,000 of the depositors' money [Complaint, App. C, p. 13a]. The losses on these loans will be approximately $17,000,000. The Dunns have served over two years of five-year sentences for criminal violations of Kentucky's savings and loan statutes, and are currently serving federal sentences for income tax evasion.

Throughout its too-long history, Prudential was audited at least annually by the Commonwealth [KRS 289.710 (App. A, p. 5a)]. State-chartered savings and loan associations were charged a fee by the Commonwealth for this auditing function [KRS 289.730 (App. A, p. 6a)]. The results of the audit were secret and were not available to the investing public [KRS 289.710]. Throughout the period, therefore, the depositors had only one indication of Prudential's condition—the fact that the Commonwealth had examined Prudential and had not taken any action. The depositors relied upon the Commonwealth's examinations as a representation that Prudential was solvent and

being operated in a safe, sound manner. Nothing could have been farther from the truth.

The irregularities in Prudential's books were covered up by the Commonwealth's bank examiners. In payment for this service, the wife of one examiner received over $250,000 in "advertising" fees [App. A, p. 16a]. The Commonwealth withheld information from the investing public, violated its own criminal laws and committed fraud in violation of the Federal Securities Acts.

REASONS WHY THIS PETITION SHOULD BE GRANTED

If the lower courts are affirmed, the Federal Securities Acts will contain a strange anomaly—the state's employees will be liable for their stock fraud, but the entity which received the money will be able to retain the benefits with impunity.

We have found no case which by final judgment subjected a state to suit in Federal Court for fraud by it in the issuance of its securities. We have found only one other case involving other state activities in the securities market—*MacKethan* v. *Commonwealth of Virginia,* 370 F. Supp. 1 (E.D. Va. 1974). In that case the District Court dismissed for lack of jurisdiction under the Eleventh Amendment. The Fourth Circuit affirmed in a per curiam opinion. A petition for certiorari (No. 74-1198) is presently pending before this Court. *MacKethan* is remarkably similar to this action, and all arguments in that case apply here with equal force.

To our knowledge, these are the first cases to reach this Court on the issue of whether the Federal Courts have jurisdiction to hear cases against states arising out of their activities in the securities market.

The basic issue is the extent to which states may make representations to the investing public without fear of liability for their violations of the Federal Securities Acts. The recent financial crisis of the City of New York graphically demonstrates the problem. Had a default occurred on New York City's hundreds of millions of dollars of debt, there might well have been a cause of action under the Federal Securities Acts. Yet, under the lower court rulings here and in *MacKethan,* the creditors and security holders could not have sued the one entity which had the ability to compensate the losses—the government which had committed the fraud. Congress could not have been so blind as to wish such a monumental loss to be without a remedy.

This case and the *MacKethan* case are, therefore, ones of first impression, involve an issue of overriding public importance, and should be passed upon by this Court.

I.

Congress Has Expressed Its Intent That States Be Subject to the Fraud Provisions of the Federal Securities Law—There Is Jurisdiction Even Under *Employees* and *Edelman*

The District and Circuit Courts have erred in the application of the law; this Court should grant certiorari and reverse this grave miscarriage of justice.

BLEED THRO

The Eleventh Amendment to the United States Constitution deprives the Federal courts of jurisdiction to hear cases brought against a state by a citizen of the United States. In *Parden,* this Court held that a state could impliedly waive its jurisdictional immunity. In *Employees* and *Edelman,* the Court severely restricted the test for implied waiver. Even under the narrow test, however, implied waiver exists in this action.

Under *Employees* and *Edelman,* a state may be sued in Federal Court only if Congress has expressed a clear intent to subject states to federal jurisdiction. As stated by this Court in *Edelman* at page 672, the test is:

> The question of waiver or consent under the Eleventh Amendment was found in those cases *(Parden, Employees* and other citations therein) to turn on whether Congress had intended to abrogate the immunity in question, and whether the State by its participation in the program authorized by Congress had in effect consented to the abrogation of that immunity.
>
> * * *
>
> Constructive consent is not a doctrine commonly associated with the surrender of constitutional rights, and we see no place for it here. In deciding whether a State has waived its constitutional protection under the Eleventh Amendment, we will find waiver only where stated "by the most express language or by such overwhelming implications from the text as [will] leave no room for any other reasonable construction." *Murray* v. *Wilson Distilling Co.,* 213 U. S. 151, 171 (1909).

Section 17(c) of the 1933 Act specifically provides that exemptions set forth in Section 3 of the Act (including an exemption for state activity) do not apply for purposes of the fraud provisions. Section 2(2) of the 1933 Act specifically includes "a government or political subdivision thereof" in the definition of "person." Hence, the 1933 Act is quite specific in applying Section 17(a) to state governments. Similarly, there are no exemptions of government activity in Section 10(b) of the Exchange Act.

In view of the specific coverage in the 1933 Act and of the lack of any exemption in the 1934 Exchange Act, the only "reasonable construction" is that Congress has expressed its intent "by the most express language," and by "overwhelming implications" that states be subject to the fraud provisions of the Federal Securities Acts.[4]

---

[4]While this Court has not passed on the issue, lower courts have consistently held that securities issued by state and local governments are subject to the fraud provisions. *See, SEC* v. *Charles A. Morris & Associates, Inc.*, 1972-73 CCH Sec. L. Rep., ¶93,756 at 93,303 (W.D. Tenn. 1973); *Int. Ladies Garment Workers Union* v. *Shields & Co.*, 209 F. Supp. 145, at 147 (S.D. N.Y. 1962); *Baron* v. *Shields*, 131 F. Supp. 370, at 372 (S.D. N.Y. 1954); *Texas Continental Life Ins. Co.* v. *Dunne*, 307 F. 2d 242 (6th Cir. 1962).

The Securities Act Amendments of 1975 (Senate Bill 249), signed by President Ford in May, 1975, further express the concern of Congress with state activity in the securities market. For the first time, the Securities and Exchange Commission has been given jurisdiction over brokers dealing solely in state-issued securities. The abuses by states and by other parties acting for states or dealing in state-issued securities have been so numerous and so severe that Congress has increased the direct federal regulation of the brokers involved.

The Securities and Exchange Commission has made clear its position that state and local securities are subject to the fraud provisions; it recently asserted jurisdiction over a revenue bond issue, and successfully sought an injunction against persons involved in the issue, *SEC* v. *The Senex Corp., et al.*, No. 74-53 (E.D. Ky. 1975).

It is extremely important to note that the activity complained of here—auditing—would subject a private party to liability.[5] In *Parden* this Court pointed out the difficulty in allowing a state to engage in acts with impunity while private parties could be sued:

> States have entered and are entering numerous forms of activity which, if carried on by a private person or corporation, would be subject to federal regulation. In a significant and increasing number of instances such regulation takes the form of authorization of lawsuit by private parties. To preclude this form of regulation in all cases of state activity would remove an important weapon from the congressional arsenal with respect to a substantial volume of regulable conduct. 377 U. S., at 197-198.

The Commonwealth should not be allowed to engage in a proprietary auditing business without subjecting itself to the same liability imposed on private auditors. To do so would seriously undermine the prophylactic effect of the Federal Securities Acts.

Congress has specifically provided that states are subject to the Federal Securities Acts; the *Employees-Edelman* test has been satisfied. This Court should grant certiorari and reverse the Sixth Circuit.

---

[5] *Competitive Associates, Inc.* v. *Laventhal, Krekstein, Horwath & Horwath*, ____ F. 2d ____, 1975 CCH Sec. L. Rep., ¶95,090 (2d Cir. May 8, 1975); *Blakely* v. *Lisac*, 357 F. Supp. 255 (D.C. Ore. 1972); *Herzfeld* v. *Laventhal, Krekstein, Horwath & Horwath*, 73-74 CCH Sec. L. Rep. ¶94,574 (S.D. N.Y. 1974).

II.

This Court Should Reassess Its Treatment of the Eleventh Amendment Under *Employees* and *Edelman*

If the Court should conclude that the *Employees-Edelman* test has not been satisfied, then Petitioner will indeed have a right without a remedy. Under state remedies, the Petitioner could not bring suit in court and obtain a trial by jury. Rather, he would be relegated to an administrative proceeding before the Board of Claims of Kentucky [KRS 44.070, App. A, pp. 4a-5a]. Individual recoveries are limited to $20,000, and liability is limited to acts of negligence, thereby depriving a substantial number of investors of a full and complete restitution. If these federal rights are to be enforced at all, they must be enforced in the United States District Courts.

The test under *Employees* and *Edelman* looks to the intent of *Congress* to find a *waiver* by the *state*. We respectfully submit that *Employees* and *Edelman* tend to confuse the test of waiver under the Eleventh Amendment with the test of whether a state is subject to federal jurisdiction under the Supremacy Clause. The *Employees-Edelman* test is totally appropriate under the Supremacy Clause; there the test is the intent of Congress in overriding a competing state interest. Under the Eleventh Amendment, however, the sole question is waiver. Waiver is a voluntary act; the test should look to the actions of the *state*, not of Congress.

The Court should re-examine *Employees* and *Edelman* and should establish a new test to determine the

BLEED TH

existence of waiver. Under a proper test the waiver must arise from some voluntary act by the state, not from the intent of Congress. Congress cannot waive a state's right; only the state can do that.

We believe waiver has occurred here. The errant state activity is the accounting function performed by the Commonwealth in conducting examinations of Prudential. We emphasize that we are *not* complaining of the exercise by the Commonwealth of its regulatory powers over savings and loan associations or over securities. Rather, we contend that by voluntarily conducting its own examinations, an activity which just as easily could have been performed by a private accountant, the Commonwealth waived its Eleventh Amendment protection.

The voluntary nature of the Commonwealth's actions are clear. In 1964, the entire savings and loan statute was revised and rewritten [1964 Ky. Acts, Chapter 138]. Secret examinations were continued in the new statute. This action was taken *after* Prudential had been seized by the Commonwealth and later returned to its management. After Prudential failed, the Commonwealth took a step which will eliminate state auditing: all such associations are now required to have deposit insurance with the Federal Savings and Loan Insurance Corporation, thereby shifting the auditing to the Federal Government [KRS 289.024, 289.451, 289.461]. If only the Commonwealth had done this earlier, Prudential's depositors would have saved millions of dollars. Instead, the Common-

OUGH

POOR COPY

wealth voluntarily erected a shield—secret state auditing—behind which the Dunns could hide the truth. By doing so, the Commonwealth represented to each depositor that Prudential was a sound investment. This voluntary deception waived the Commonwealth's rights under the Eleventh Amendment.

We respectfully submit that the focus of the Court's attention under the Eleventh Amendment should be on the state, not on Congress. The *Edelman* test is appropriate under the Supremacy Clause. Where, however, a state voluntarily conducts an auditing business for a fee, and thereby represents to the investing public that an institution is sound, the state has by its own hand waived its Eleventh Amendment immunity.

CONCLUSION

Even under the strict test of the *Employees* and *Edelman* cases, the Congress has expressed an intent that citizens have a federal remedy to enforce their federal rights under the Federal Securities Acts. Even if the Court should conclude that the *Employees-Edelman* test has not been met, the Court shoud reassess its holdings in *Employees* and *Edelman,* for their effect would be to create a right without a remedy. If the dismissal stands, then Prudential's 11,000 investors will be in just such a position. They will have suffered grievous loss as a result of a massive fraud in flagrant violation of the Federal Securities Acts. Yet, they will have no forum in which to vindicate their federal rights. They will, indeed, have a right without a

BLEED THR

remedy. The Court should grant the writ and hear this case on the merits.

Respectfully submitted,

ARTHUR W. GRAFTON
STUART E. LAMPE
JAMES N. WILLIAMS, JR.
WYATT, GRAFTON & SLOSS
28th Floor—Citizens Plaza
Louisville, Kentucky 40202
Counsel for Petitioner

OUGH
POOR COPY